CENTRAL AMERICA:
PROSPECTS FOR ECONOMIC DEVELOPMENT AND INTEGRATION

by

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November 1991

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Abstract

This paper examines the external and domestic determinants of the economic crisis experienced by the Central American nations in the 1980s. Both long-term, structural trends, and short-term, unfavorable shocks contributed to the crisis. Protectionist import-substitution industrialization caused stagnation and reduced flexibility in adjusting to external shocks. Borrowing abroad made it possible to postpone required adjustments. Most reconstruction programs recommend massive flows of foreign financial assistance for Central America. The paper critically reviews the role of financial assistance, particularly in the light of political-economy pressures that lead to fiscal deficits, and claims that too much aid causes delays in needed policy reforms. Given the urgency of becoming competitive in world markets, the paper is pessimistic about the role of the Central American Common Market, beyond providing free trade within the region.
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Introduction

During most of the past decade, the Central American nations have been in the midst of an acute financial and economic crisis, characterized by a stagnant and at times contracting output; by an even more rapid decline of their international trade, with sluggish export growth and a sharp reduction in their imports; by unemployment and underemployment well above their historical levels; by huge public-sector deficits and the corresponding growth of their public external borrowing, followed by their inability to service this debt as it was

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1 Paper prepared for the Regional Security Conference on Political and Economic Reconstruction in Central America, organized by the International Institute for Strategic Studies (London) and the Centro de Investigación y Adiestramiento Político-Administrativo (San Jose), held in San Jose, costa Rica on May 12-16, 1991.

2 The author is Professor of Agricultural Economics and of Economics at The Ohio State University and former Dean of the Faculty of Economic Sciences at the University of Costa Rica.

3 Between 1980 and 1985, all the five countries exhibited some negative rates of growth of Gross Domestic Output (GDP). As a consequence, by 1987 real per capita incomes were at levels that had already been attained before the 1970s (World Bank, 1990).

4 While for 1975-1980, total exports accounted for 27 percent of the region's GDP, in 1985 the ratio was only 22 percent (World Bank, 1990).
originally contracted; by accelerating, either repressed or open inflation, and by the accompanying, explicit or implicit devaluation of their domestic currencies.

In addition to impoverishment and economic instability, major political and social tensions, including armed conflicts, have extracted a heavy toll in lost human and physical resources. These difficulties have been in sharp contrast with the record of rapid economic growth of the previous two decades, particularly after the creation of the Central American Common Market (CACM) in the early 1960s, and with an even more spectacular record of price and exchange rate stability, that lasted for several decades.

These difficulties have thus represented the worst economic crisis that this region had experienced since the Great Depression of the 1930s, when a sharp decline in the international demand for and in the price of coffee and bananas, the area's main export crops, coupled with a substantial increase in the real value of the service of their external debt, severely impoverished these countries. In the 1980s, once again, service of the region's external debt, which grew from US$ 5.6 billion in 1978 to US$ 16.8 billion in 1986, coupled with diminishing access to additional foreign funds, became one of the critical economic policy issues for the Central American authorities.

The economic and financial crisis has had major consequences on the institutional fabric and political structures of the countries of the region, whose analysis is well beyond the scope of this paper. Clearly, political instability has been both a cause and a conse-

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5 Between 1978 and 1986, the Central American countries increased their foreign debt by US$ 11.2 billion, three times the amount outstanding in 1978 (López, 1990). Over 13 reschedulings, frequent arrears, and occasional moratoria indicate these countries' inability to service these debts.
sequence of these economic difficulties. What is important to recognize, however, is that major problems of economic adjustment would have characterized the recent history of the Central American countries even in the absence of political turmoil.  

As a result of these endogenous determinants of the crisis, to be discussed below, in addition to the recovery of political stability and institutional performance, drastic policy changes and substantial adjustments will be required for renewed growth and stability. Some of the Central American countries have already undertaken initial steps in the process of structural adjustment that is required, but the region has yet to fully recover from the crisis and sustainable development will take more ambitious reforms still. Too much attention to the geopolitical circumstances of the moment may sometimes unfortunately lead, however, to politically expedient approaches that may, in the long run, aggravate rather than alleviate the economic problems of the region.

**Determinants of the Crisis**

The difficulties experienced by the Central American countries in the 1980s resulted from a combination of long-term trends and unfavorable short-term circumstances, both for-

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6 In at least two countries (Costa Rica and Honduras) war, insurrection, and political instability have not been a major determinant of the economic crisis.

7 Costa Rica began a broad-based structural adjustment program in 1985 and made substantial progress, until renewed fiscal difficulties in 1990 slowed down the process. Guatemala introduced a stabilization program in 1986, with considerable success as well, but has also experienced recent difficulties. After June, 1989 the new Administration in El Salvador embarked on a process of gradual liberalization. These attempts have been even more recent and less successful in Honduras, while Nicaragua has encountered severe difficulties in maintaining macroeconomic control and continues to experience political turmoil, which limit the scope for economic policy reforms.
eign and domestic. The long-term, structural determinants of the crisis, whose unfavorable effects accumulated slowly but steadily, reflected a contradiction between the region's most basic economic characteristics and the features of the protectionist strategy of import substitution industrialization adopted in the late 1950s and incorporated in the policy framework of the CACM.

The most basic feature of the Central American economies is their small size, with the limitations imposed by a narrow, specialized resource base and a poor domestic market. Even the five countries together, with a joint GDP of US$ 21.6 billion in 1986, are a very small market. Traditionally, therefore, the region has relied on international trade as its engine of growth. Although the creation of the CACM led to a significant increase in intra-regional trade, the adoption of a high common external tariff emphasized inward-looking incentives for resource allocation. Market size is critical for successful industrialization, however, because it determines the degree of viable specialization, the scope for the exploitation of economies of scale, and the extent of competition. In Central America, limited market size led to the establishment of many high cost industries. The resulting penalization of agriculture and the bias against exports gradually reduced the possibilities for sustained growth.

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8 Equivalent, for example, to Ireland, with a GDP of US$ 21.9 billion in 1986, or to an American city such as Phoenix, Arizona.

9 Intraregional trade increased from 7.5 percent of the region's total exports in 1960, to 26.8 percent in 1970. Much of this increased trade reflected, however, welfare-reducing trade diversion.
Contrary to its declared objective, import substitution did not reduce the region’s dependence on agricultural exports, whose growth through the mid-1970s facilitated the expansion of intraregional trade. Manufactured exports increased, but in the context of the protected customs union; most of the protected industries were not competitive in third country markets. With the inevitable eventual exhaustion of the early easy stages of import substitution, growth opportunities disappeared.

Moreover, the cascading pattern of nominal protection, with the highest rates on final consumer goods and the lowest rates on intermediate inputs and capital goods, fostered an import-intensive manufacturing sector, unable to compete in world markets, thus imparting an anti-export bias to its development. With the balance-of-payments difficulties of the mid-1970s, adjustment policies became harder to adopt. Required reductions of imports after a negative external shock implied a reduced availability of the inputs needed for continued industrial production and employment and were thus postponed. Faced with this dilemma, the Central American governments chose to increase their borrowing abroad, with negative consequences on their future growth opportunities.  

Another key feature of the Central American economies is their relative abundance of labor. The protectionist strategy distorted not only relative commodity prices, turning the domestic terms of trade against agriculture; it also distorted relative factor prices, thereby underpricing capital and overpricing labor in the modern sector of the economy. These

policies included tax exonerations on investment and duty-free imports of capital goods, exchange rate policies that overvalued the domestic currencies, and subsidized credit. While trade policies favored manufacturing, the most capital-intensive sector, factor price policies favored capital-intensive technologies in all sectors.

These factor-price policies limited the opportunities for labor absorption in the private modern sector, where productivity and wages are higher, this forcing the public sectors to become active employers of last resort, in order to avoid higher unemployment rates. The rapid growth in low-social-productivity public-sector employment fueled a growing fiscal deficit, that has been at the root of the financial crisis of the 1980s. The importance of public sector labor unions, on the other hand, has made it politically difficult to cut public sector expenditures and thereby has contributed to the accumulation of external borrowing, in order to postpone the required fiscal adjustment.

The short-term determinants of the crisis, on the other hand, have reflected major external shocks, political turmoil, and the unfortunate domestic policies adopted in response to the shocks. These external influences included sharp swings in the region's international terms of trade and drastic changes in the conditions of access to international financial markets. War, insurrection, and political instability reinforced the unfavorable trends implicit in the protectionist strategy of import substitution, while the associated uncertainty has contributed to the decline of gross domestic investment.

When the stagnation and contraction of real incomes in the early 1980s reduced the rate of growth of government revenues, the Central American governments faced severe political and administrative constraints for an additional mobilization of domestic resources
with the use of the conventional tools of taxation. It became difficult to increase taxes in the middle of an economic recession, given pessimistic expectations and intense capital flight. Several attempts at tax reform did not bear the desired revenues. At the same time, public-sector expenditures and implicit, non-recorded subsidies and entitlements to various social groups kept growing, at rates increasingly faster than those associated with revenues. Narrow securities markets offered few opportunities to finance the public sector.

Given the increasing discrepancy between public-sector revenues and expenditures, for a while the authorities financed budget deficits by placing their debt abroad. When the limit to the stock of public external debt that foreign lenders were willing to accumulate was finally reached and programmed expenditures had not yet been reduced, the Central American governments forced the placement of their debt with the domestic financial system. Domestic financing of public-sector deficits had two consequences. Too rapid an expansion of domestic credit led to the loss of international monetary reserves, to accelerating inflation, and eventually to devaluation. The rate of domestic credit expansion was no longer compatible with the traditional price and exchange-rate stability. On the other hand, the private sector was severely crowded out of domestic credit portfolios. Thus, growing fiscal deficits were financed with the loss of international monetary reserves, accelerating borrowing abroad and, finally, with the inflation tax and the financial repression of the private sector.

To avoid the inflation tax (as well as the uncertainty from political instability), the Central Americans revised their wealth portfolios, reduced their holdings of domestic financial assets, and increased their holdings of tangible assets (inflation hedges) and of foreign
assets (currency substitution). Controls over interest rates and exchange rates, combined with inflation and devaluation expectations, further fueled capital flight. Among the consequences was a severe contraction of the domestic financial systems, as inflation eroded the real value of credit portfolios and of deposit liabilities and as economic agents moved away from domestic currencies.

With inflation and devaluation, the opportunity cost of holding domestic financial assets has increased. These assets have become poor stores of value and have forced savers to look for alternative ways to hold wealth. As a result, the financial sector has shrunk. This, in turn, has reflected an abuse of the fiscal function of financial markets, which has reduced their ability to promote stability and growth. This is unfortunate, because financial intermediation is critical during periods of structural adjustment and resource reallocation.  

In summary, the recent economic difficulties of the Central American nations have reflected both long-term trends and short-term shocks. Some of these factors have been beyond their control, while others have been the result of the way in which the authorities have responded to those events. Strategies and policy regimes that have been in contradiction with the region's basic economic characteristics have led to stagnation and instability. Sustainable development requires major policy reforms, in order to promote private investment, increase competitiveness in world markets and export performance, mobilize a larger volume of domestic savings and channel them more efficiently towards socially profitable

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activities, and regain control of the public sector finances, in order to avoid inflation and capital flight. The new policy package must include more flexible exchange rate policies, lower tariff protection to manufacturing, financial reforms to promote the mobilization of voluntary domestic savings and increased competition in credit markets, and a reduction of public sector expenditures.

**Foreign Financial Assistance**

Political turmoil, insurrection, and the fragile prospects for long-term peace in Central America have attracted considerable international attention. Since economic stagnation and instability have been major dimensions of the recent history of the region as well, it is not surprising that numerous plans and programs have been proposed to deal with these problems.

The most common set of responses has been to request, on the one hand, and to offer, on the other, substantially increased flows of foreign financial assistance. As a key example, in mid-1983, President Reagan established a National Bipartisan Commission on Central America, headed by Dr. Henry Kissinger, to propose elements of a long-term strategy for the region. In its 1984 Report, the Kissinger Commission recommended greatly expanded economic assistance. Legislation, known as the Central American Initiative, was passed authorizing US$ 8.4 billion in bilateral assistance for the fiscal years 1984-1989.\(^ {12} \)

Although the Commission recognized that "large-scale economic aid alone does not guarantee progress," and that "the effectiveness of increased economic assistance will depend

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on the economic policies of the Central American countries themselves," in practice the major legacy of the Commission has been the significantly increased flows of financial aid granted during these five years, which have, in turn, been consistent with the geopolitical interests of the moment.\(^{13}\)

The disbursing of large amounts of foreign financial aid may be a far more complex and difficult exercise than is usually recognized.\(^{14}\) A major question is the extent to which foreign aid and international financial flows, in general, can contribute to growth and stability in the region. This is not an easy question to answer. The success of the Marshall Plan in the late 1940s and in the 1950s led many to believe that similar transfers of funds to the developing countries would permit their comparably spectacular transformation. It is thus not surprising to observe periodic calls for a "Marshall Plan for Central America."

The optimism inherent in this view has been gradually replaced, however, by a better understanding of the complexities of the process of economic development, while a few economists, at the other end of the spectrum, have actually claimed that the absence of foreign

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\(^{13}\) See Congressional Research Service, "Kissinger Commission Implementation: Action by the Congress through 1986 on the Recommendations of the National Bipartisan Commission on Central America," Report No. 87-291. Washington, D.C.: U.S. Government Printing Office. To the extent to which foreign assistance conditionality has contributed to the adoption of growth-promoting policy reforms in some countries, it has had a beneficial impact (See "The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Costa Rica, AID Evaluation Highlights, No. 1, October 1988). This requires, however, the previous existence of a local commitment to the reforms, a commitment that may be weakened by the availability of large amounts of aid.

aid is almost a prerequisite for economic progress in the developing countries.\textsuperscript{15} In the early days (1950s), emphasis on the role of foreign financial assistance was based on the implicit assumption that the key input in the process of economic growth was physical capital and that the shortage of investment, as a consequence of low domestic savings rates, was the critical bottleneck in the process of economic development.

The validity of the presumption of a positive association between the volume of capital inflows and the rate of economic growth has not been demonstrated, however. The assumption has been that the foreign resources would add to domestic savings, in order to increase total investment.\textsuperscript{16} Some of the available empirical evidence shows, nevertheless, a possible negative relationship between the inflows of foreign financial assistance and the share of domestic savings in the gross domestic product.\textsuperscript{17}

In effect, the foreign funds have frequently substituted for domestic savings, increasing both consumption levels and the extent of capital flight. The additionality of the foreign funds has thus been low. This should not be surprising, given the fungibility of funds and a marginal propensity to save of less than one. Inevitably, the recipient will allocate the extra resources partly for present and partly for future consumption. The extent of this leak-


age may be considerable, particularly when domestic incentives to save are distorted. Moreover, because funds are fungible, they have the effect of freeing resources for other uses and, as a result, actual changes in marginal resource allocation do not necessarily correspond to the intentions of the foreign aid program.

Furthermore, even if the foreign funds were used solely for productive investment projects that otherwise would not have been undertaken, future income and future wealth would rise and hence savings out of current measured income would fall. Finally, as economic agents see foreign debt rise, they may well anticipate increased future tax burdens for its servicing and will, therefore, have incentives to transfer assets abroad. A most striking example of this behavior is the extent to which, in several of the large debtor countries, as well as in Central America, private capital outflows have eroded the net inflows. It has been estimated that up to a half or more of the increase in the gross indebtedness of Argentina, Mexico, and Venezuela during 1974-1982 was offset by private capital outflows. These outflows mean that borrowing by these countries added much less to domestic resources than was originally thought.

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19 It has been estimated that up to a half or more of the increase in the gross indebtedness of Argentina, Mexico, and Venezuela during 1974-1982 was offset by private capital outflows. In the 1980s, domestic fixed capital formation declined in these countries. Since funds invested abroad usually escape the tax base of the borrowing-country government, these outflows have actually increased the cost to these countries of raising revenue to service their debt and have thus reduced their prospects for debt repayment. John T. Cuddington, "Capital Flight: Issues, Estimates, and Explanations," *Princeton Essays in International Finance*, Study 58, December, 1986.
The link of foreign financial assistance with the rate of economic growth through the levels of savings and investment may thus be weak. Of greater concern is the impact of foreign aid on the efficiency of domestic resource allocation. Foreign aid flows, for example, tend to overvalue the domestic currency and thereby have a negative impact on the competitiveness of the country’s exports.\(^{20}\)

It has been claimed, in addition, that government-to-government aid can easily contribute to unproductive investment and to the perpetuation of interventionist economic policies that increase capital-output ratios. A leading Guatemalan wrote for the *Wall Street Journal* that "the combination of have-money-must-lend international institutions and of spendthrift politicians has been one of the main causes of the sad state of economic affairs in Latin America."\(^{21}\)

This is not the place to fully explore the causes of the wealth of nations or the complexities of the process of economic development. Since the time of the Marshall Plan, nevertheless, our understanding of the development process has deepened significantly, beyond the views that physical capital was the main input lacking for economic growth. Current thinking places equal emphasis on human capital formation, on the importance of financial deepening and of well-functioning markets, and on the role of international trade,

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\(^{21}\) Manuel Ayau.
of entrepreneurship, of technological innovations, and of policies that encourage competition.\textsuperscript{22}

What matters, then, is the accumulation of resources, in both a quantitative and qualitative sense, and an increased efficiency in resource use, from the economic, managerial, and engineering perspectives. Achievement of these goals depends on many factors, including the incentives facing individuals for the accumulation and efficient use of resources, the development of well-functioning markets, efficient financial intermediation, adequate government provision of infrastructural services, and institutional development in both the private and the public sectors. The modern view of development focuses, in particular, on improving markets, through the promotion of the institutional framework (property rights, contracts, courts), government provision of public goods (agricultural research and extension services), and the removal of the government-imposed impediments to economic efficiency, that result from the whole set of price interventions and other regulations that drive a wedge between private and social profitability. Foreign financial assistance can play only a limited role in this connection.

Further, as described above, the economic experience of the Central American countries during the late 1970s and early 1980s was dominated by large external shocks and the accompanying balance of payments crises. Major examples were the two oil shocks and the coffee boom, followed by the world recession of the early 1980s. Such crises have necessitated a reduction in the level of aggregate current expenditures. The traditional view in

these cases has been that, if the proper stabilization-and-adjustment measures are undertaken, the country may be able to obtain additional foreign financial assistance as well as other resource inflows, which could allow a gradual, rather than a sudden reduction in real expenditures. That is, it may be possible to alleviate the crisis by persuading foreign creditors to extend more credit and foreign donors to provide more aid.

Because time is required for the movement of productive factors and of consumption patterns, the short-term effect of the shock will be an overshooting of the value of foreign exchange, in comparison to its new long-term equilibrium level. If the economy were to adjust instantaneously to the new equilibrium value of the exchange rate, there would be no justification for the extra borrowing. If that is not the case, however, it may then pay to borrow during the first years of the transition after the shock, against the period when the scarcity price of foreign exchange is lower, because the full resource and demand reallocations have already taken place. This more gradual approach to close the deficit thus requires extra external borrowing.

The key implicit assumption of this analysis is, however, that changes in the elasticity of supply and demand are exogenous and only a function of time. Therefore, when the extra borrowing evens out the path of the exchange rate, it is assumed that this smoothing does not affect the speed at which the short-run values converge to the long-run equilibrium levels. The increase in the elasticity of response is assumed to be independent of the path of prices or of incentives. Concern with the impact of foreign financial assistance, on the other hand, grows from the perception that these elasticities are endogenous and that they tend to decline with the inflows of foreign funds.
Ample access to foreign financial assistance during a balance-of-payments crisis may thus not be welfare improving, once the endogeneity of the elasticities of response is recognized. Most balance of payments crises are in large part crises of the public sector and reflect misjudgments about the appropriate and feasible size and composition of the state. They may reflect excess absorption generated by monetary expansion accompanying government expenditure during the political cycle. They may also reflect an increase in government expenditures that is unsustainable over the long run. This will occur if the government misjudges the size of future annual foreign exchange flows that result from a positive shock, such as the coffee boom, and commits itself to unsustainable consumption-support programs, which would need to be cut back if there were any falling off in the expected foreign exchange rents.

Fiscal crises may also reflect the creation of politically-determined entitlements to current and future income streams for various groups in the economy, such as tax holidays for protected manufacturers or non-traditional exporters, subsidized credit for small farmers, food subsidies for low-income households, and above-market wages for public sector employees. These entitlements are difficult to eliminate; they can be removed only at a high political cost. Since they represent explicit or implicit subsidies to particular groups, they have to be paid for with the explicit or implicit taxation of other groups (or with the use of foreign savings). Given inelastic public sector revenues, these expenditure commitments lead to fiscal deficits that become chronic. These deficits can be financed by foreign borrowing, domestic borrowing, or the levying of the inflation tax.
The Central American countries have tried all three methods of financing a growing public sector, with dire consequences. Domestic borrowing to close the fiscal gap has crowded out private investment in credit portfolios and has reduced the rate of output growth. Inflation has repressed the domestic financial system. Financing the deficit with foreign savings was the preferred strategy, as long as access existed. Many believed that this was a costless method of financing these expenditures. The ability of the Central American countries to service their external debt declined, however, when world real interest rates rose and an unfavorable international environment and distorting domestic policies repressed exports.

The decision of the authorities to transform a fiscal deficit into a foreign debt issue had already compromised future growth, for the sake of sustaining artificial consumption levels in the short run. Furthermore, access to foreign savings strengthened the reluctance of the authorities to devalue, even when the domestic currency had become highly overvalued. As a result, those with access to the scarce foreign exchange enjoyed a valuable entitlement. In the end, this was an implicit subsidy to the massive process of capital flight that took place. The returns from the externally borrowed resources were thus privatized, while the service of the foreign debt was socialized.

Under ideal circumstances, therefore, foreign financial assistance would add to domestic savings and thus contribute to economic growth in Central America. Under less ideal circumstances, however, the foreign funds may sustain growth-reducing policies. They may make it possible for a too large and bureaucratic sector to continue expanding. In extreme cases, these funds may make it possible for the authorities to finance socially unprofitable
investments, such as those undertaken earlier by the public development corporations of the region (CODESA, CONADI). Large amounts of foreign assistance make take away the incentives for increased domestic resource mobilization. In particular, abundant foreign financial assistance may neutralize the healthy impact of the crisis on the transformation of economic policy regimes. By bailing governments out, it may allow the persistence of unsustainable entitlements and of distorting policies. Too much aid weakens the commitment to reform.

Moreover, when the political support for the region eventually disappears in the future, the Central American countries will suddenly find that they have built up their public sector expenditures to unsustainable levels, but have not mobilized their own resources to cover for those expenses. So, whenever there will be a shortfall in the infusions from abroad, or a closing of the spigot, they will be left high and dry, with tremendous deficits again, and no incentives for local resource mobilization. When this happens, as in the past, economic instability will return to the region.

Some may claim that recent foreign aid has been made conditional upon effective policy changes that have been beneficial. Ignoring questions of sovereignty, aid, by itself, is not sufficient to promote such reforms (as the case of Honduras exemplifies), particularly after the levels of aid have been announced, for geopolitical reasons. It is only when sufficient local commitment to the policy reforms exists (as in Costa Rica), that limited foreign assistance can play a positive role.

The long-run economic problem of the Central American countries is how to augment the quantity and improve the quality of its resources. A better system of incentives
and less distorted markets, which are a necessary but not a sufficient condition, merely provide better opportunities for the allocation of existing resources. Growth depends, however, on the accumulation of real resources and on improvements in the efficiency of their allocation, on technological innovations, on the ability to identify new opportunities and the willingness to accept risks in order to take advantage of them. The long-run economic development of Central America depends on all of these determinants of economic growth. The provision of foreign savings, although not a substitute for this process of accumulation of human and physical capital, knowledge, and managerial abilities, may assist in the process, if proper precautions are taken.

Foreign assistance may help improve, in particular, the education and health of the Central Americans. When normality returns, they will continue to be poor, unless their skills are improved. Despite difficulties, improvements in sanitation, water supplies, sewage disposal systems, and the like, are projects that foreign donors may finance, particularly in view of the contraction of public investment during fiscal crises. Equally important is the transmission of knowledge and the training of the Central American labor force. There is a positive role for foreign assistance to play in this connection, that may compensate the dangers from abundant additional funds for the public sector.

Economic Integration

As in the past, international trade will continue to be the engine of growth in Central America, in view of the small economic size of the region. The pursuit of the import-substitution industrialization strategy associated with the CACM can no longer offer, moreover, a promising vehicle for sustainable growth. The question is, therefore, whether there would
be any point in reviving the CACM, if the Central American countries are prepared to embark on the course of trade liberalization that this implies. In principle, regional integration does not make much sense when full trade liberalization is a feasible alternative, since it would be an implicit byproduct of international integration.

In the trade liberalization programs that the Central American countries have already adopted, trade barriers are to be reduced gradually and some tariffs are expected to remain at the end, mostly for fiscal purposes. This implies that domestic industries will still receive some protection, during the transition, and after the reforms are completed. The removal of intraregional barriers would be desirable in this context, therefore, to allow benefits from greater opportunities for specialization and economies of scale. Although the regional market is small, by international standards, it is still larger than each national market.

Given the geographical proximity of the Central American countries, trade in otherwise nontradeable commodities might be promoted, particularly along the borders, and smuggling discouraged, while effective economic integration could improve the basis for political cooperation and thus help defuse current tensions in the region. These arguments


24 There is still a danger that the resulting trade diversion effects outweigh the trade creation and trade expansion effects. This is less likely today, however, since no rediversion of trade was observed after the crisis, and the existing excess capacity in these industries makes new (distorted) investment unnecessary. In addition, the reduction of intraregional trade barriers would take place in the context of much lower extraregional barriers.
favor regional integration in the context of an overall freer trade environment, but not as an alternative to trade liberalization. The main purpose would be the elimination of the impediments to trade (mostly exchange controls) adopted as part of the macroeconomic management programs of the 1980s and the renewed operation of the regional payments clearing house (Cámara de Compensación Centroamericana).25

A regionally coordinated policy strategy may be required. A revision of the common external tariff, with reduced rates, the elimination of specific tariffs, and the cancellation of the regional system of fiscal incentives were already adopted in January, 1986. Individual countries have further proceeded with additional phased reductions of the tariff ceiling. Effective protection is still significant, however, in view of the reductions in the tariffs on raw materials and intermediate inputs. Further tariff reductions are, therefore, critically important. A unified tariff of between 10 and 20 percent would generate enough revenues to maintain balance of the fiscal accounts. The Central American governments have signalled a commitment towards trade liberalization.

In view of the current economic and political disparities in the region, nevertheless, a unified approach to trade liberalization may be difficult. It may be preferable to allow each country to initiate its own reform program at the separate speed that is best suited to its own circumstances, with a commitment to converge at a common policy target within a predetermined time horizon. This implies the suspension of the common external tariff

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during the transition and the establishment of a well-functioning free trade area. What is
important is that the momentum toward trade reform that already exists in some countries
be maintained and that they are not held back by commitments to wait until the other part-
ners have caught up with their adjustments.

A critical precondition for a successful integration is the elimination of the severe
macroeconomic imbalances in some of the countries and the realignment of exchange rates,
measures due long ago that are needed in any case for the resumption of growth and of
stability. Macroeconomic difficulties in the late 1970s and early 1980s and the increasing
reliance on exchange controls and import surcharges for macroeconomic management have
been a major cause of the sharp reduction of intraregional trade.

Regional integration may improve the effectiveness of trade negotiations with other
regions of the world (Mexico, United States, European Economic Community), on the idea
that a collective stand on issues of common interests attracts more recognition, while the
transaction costs of international negotiations are reduced. Moreover, a collective agree-
ment may help local politicians resist protectionist pressures at home. The dangers are,
however, a diversion of attention away from the more important objective of achieving over-
all trade liberalization. The process of arriving at a regional consensus on policy actions
may become excessively cumbersome and drawn out and, in the end, insufficient actions may
be undertaken. If the integration effort strengthens the lobbying power of the national
groups presently protected (and better organized), the outward-looking strategy may not be
adopted with the required vigor. The guiding principle in these cases would be that, at the
present low levels of intraregional trade, the gains from liberalization of the external trade
are bound to outweigh the potential losses from reduced intraregional trade. Delays in this connection will have a high opportunity cost. Revival of the integration process may be attractive, but much caution needs to be exercised.